

U.S. TRUST

CONFLICTS OF INTEREST – THE FIDUCIARY’S BANE

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U.S. TRUST 

Bank of America Private Wealth Management

Disclosure

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BANE - DEFINITION

The Free Dictionary: a source of persistent annoyance or exasperation.¹

Vocabulary.com: “Although ‘bane of my existence’ is a commonly heard phrase, there’s something deliciously archaic about the word bane.”²

Cambridge Dictionary: A cause of continuous trouble or unhappiness.³

Oxforddictionaries.com: A cause of great distress or annoyance.⁴

CONFLICTS OF INTEREST – THE FIDUCIARY’S BANE

- Why our focus on conflicts
 - Business case – our clients expect objective, unconflicted advice
 - Financial Services Industry reputation worse than Tech, Healthcare, Energy, Food and Beverage, Telecommunications, Auto, Entertainment
 - John Oliver
- Sources of our conflicts rules and regulations
 - Federal, State, Common law
- Unique risks arising from conflicts
 - Operational, Compliance, Reputational, Strategic
- How do we think about business practices, business models and risk framework?

FOCUS ON FIDUCIARY

- Dodd Frank Wall Street Reform and Consumer Protection Act of 2010, §913
– SEC Study – January 2011

Bank and Trust Company Regulation

Advisers Act Section 202(a)(11)(A) excludes banks and bank holding companies that do not advise investment companies from the definition of investment adviser. For purposes of this exclusion, a “bank” is defined in Advisers Act Section 202(a)(2) to include nationally chartered banks, federal savings associations, and members of the Federal Reserve System and state chartered banks if their activities are similar to those engaged in by national banks and if they are regulated by state or federal banking authorities. Section 202(a)(2) also defines a “bank” as a trust company where the substantial portion of its business consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations, and which is not operated for the purpose of evading the provisions of the Advisers Act. To the extent that banks and trust companies offer investment advisory services that may overlap with those of Commission- and state-registered investment advisers, there may be differences in the applicable regulation and standards of care.⁵

- DOL Fiduciary Rule Proposed April 20, 2015

“In 1975, the Department issued regulations that significantly narrowed the breadth of the statutory definition of fiduciary investment advice by creating a five-part test that must, in each instance, be satisfied before a person can be treated as a fiduciary adviser...Under ERISA and the Code, if these advisers are not fiduciaries, they may operate with conflicts of interest that they need not disclose and have limited liability under federal pension law for any harms resulting from the advice they provide. Non-fiduciaries may give imprudent and disloyal advice; steer plans and IRA owners to investments based on their own, rather than their customers’ financial interests; and act on conflicts of interest in ways that would be prohibited if the same persons were fiduciaries.”⁶

SOURCES OF CONFLICTS RULES AND REGULATIONS

UNIFORM TRUST CODE - SECTION 802. DUTY OF LOYALTY⁷

(a) A trustee shall administer the trust solely in the interests of the beneficiaries.

(b) Subject to the rights of persons dealing with or assisting the trustee as provided in Section 1012, a sale, encumbrance, or other transaction involving the investment or management of trust property entered into by the trustee for the trustee's own personal account or which is otherwise affected by a conflict between the trustee's fiduciary and personal interests is voidable by a beneficiary affected by the transaction unless:

- (1) the transaction was authorized by the terms of the trust;
- (2) the transaction was approved by the court;
- (3) the beneficiary did not commence a judicial proceeding within the time allowed by Section 1005;
- (4) the beneficiary consented to the trustee's conduct, ratified the transaction, or 135 released the trustee in compliance with Section 1009; or
- (5) the transaction involves a contract entered into or claim acquired by the trustee before the person became or contemplated becoming trustee.

(c) A sale, encumbrance, or other transaction involving the investment or management of trust property is presumed to be affected by a conflict between personal and fiduciary interests if it is entered into by the trustee with:

- (1) the trustee's spouse;
- (2) the trustee's descendants, siblings, parents, or their spouses;
- (3) an agent or attorney of the trustee; or

SOURCES OF CONFLICTS RULES AND REGULATIONS

UNIFORM TRUST CODE - SECTION 802. DUTY OF LOYALTY⁷

(4) a corporation or other person or enterprise in which the trustee, or a person that owns a significant interest in the trustee, has an interest that might affect the trustee's best judgment.

(d) A transaction between a trustee and a beneficiary that does not concern trust property but that occurs during the existence of the trust or while the trustee retains significant influence over the beneficiary and from which the trustee obtains an advantage is voidable by the beneficiary unless the trustee establishes that the transaction was fair to the beneficiary.

(e) A transaction not concerning trust property in which the trustee engages in the trustee's individual capacity involves a conflict between personal and fiduciary interests if the transaction concerns an opportunity properly belonging to the trust.

(f) An investment by a trustee in securities of an investment company or investment trust to which the trustee, or its affiliate, provides services in a capacity other than as trustee is not presumed to be affected by a conflict between personal and fiduciary interests if the investment 136otherwise complies with the prudent investor rule of [Article] 9. In addition to its compensation for acting as trustee, the trustee may be compensated by the investment company or investment trust for providing those services out of fees charged to the trust. If the trustee receives compensation from the investment company or investment trust for providing investment advisory or investment management services, the trustee must at least annually notify the persons entitled under Section 813 to receive a copy of the trustee's annual report of the rate and method by which that compensation was determined.

SOURCES OF CONFLICTS RULES AND REGULATIONS

UNIFORM TRUST CODE - SECTION 802. DUTY OF LOYALTY⁷

(g) In voting shares of stock or in exercising powers of control over similar interests in other forms of enterprise, the trustee shall act in the best interests of the beneficiaries. If the trust is the sole owner of a corporation or other form of enterprise, the trustee shall elect or appoint directors or other managers who will manage the corporation or enterprise in the best interests of the beneficiaries.

(h) This section does not preclude the following transactions, if fair to the beneficiaries:

- (1) an agreement between a trustee and a beneficiary relating to the appointment or compensation of the trustee;
- (2) payment of reasonable compensation to the trustee;
- (3) a transaction between a trust and another trust, decedent's estate, or [conservatorship] of which the trustee is a fiduciary or in which a beneficiary has an interest;
- (4) a deposit of trust money in a regulated financial-service institution operated by the trustee; or
- (5) an advance by the trustee of money for the protection of the trust.

(i) The court may appoint a special fiduciary to make a decision with respect to any proposed transaction that might violate this section if entered into by the trustee.

Comment

This section addresses the duty of loyalty, perhaps the most fundamental duty of the trustee. Subsection (a) states the general principle, which is copied from Restatement (Second) of Trusts Section 170(1) (1959). A trustee owes a duty of loyalty to the beneficiaries, a principle which is sometimes expressed as the obligation of the trustee not to place the trustee's own interests over those of the beneficiaries. Most but not all violations of the duty of loyalty concern transactions involving the trust property, but breaches of the duty can take other forms. For a discussion of the different types of violations, see George G. Bogert & George T. Bogert, *The Law of Trusts and Trustees* Section 543 (Rev. 2d ed. 1993); and 2A Austin W. Scott & William F. Fratcher, *The Law of Trusts* Sections 170-170.24 (4th ed. 1987).

SOURCES OF CONFLICTS RULES AND REGULATIONS

Restatement (Third) of Trusts -

§ 78 - Trustee's Duty of Loyalty: ⁸

- (1) Except as otherwise provided in the terms of the trust, a trustee has a duty to administer the trust solely in the interest of the beneficiaries, or solely in the interests of the beneficiaries, or solely in furtherance of its charitable purpose.
- (2) Except in discrete circumstances, the trustee is strictly prohibited from engaging in the transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's Fiduciary duties and personal interests.
- (3) Whether acting in a fiduciary or personal capacity, a trustee has a duty in dealing with a beneficiary to deal fairly and to communicate to the beneficiary all material facts the trustee knows or should know in connection with the matter.

SOURCES OF CONFLICTS RULES AND REGULATIONS

No Further Inquiry Rule

If a trustee undertakes a transaction that involves self-dealing or a conflict between the trustee's fiduciary capacity and personal interests, good faith and fairness are not enough to save the trustee from liability. In such a case, *no further inquiry* is made; the trustee's good faith and the reasonableness of the transaction are irrelevant. The only defenses that a trustee may raise are that: (a) the *settlor authorized* the particular self-dealing or conflicted action in the trust instrument; (b) the *beneficiary consented* after full disclosure; or (c) the trustee obtained *judicial approval* in advance.⁸ Even if the trustee has such a defense, the beneficiary remains entitled to judicial review of whether the trustee acted in good faith and of the fairness of the transaction,⁹ reflection a mandatory core of fiduciary obligation that cannot be waived.

A trustee may be authorized by the terms of the trust, expressly or by implication, to engage in transactions that would otherwise be prohibited by the rules of undivided loyalty....[H]owever,... no matter how broad the provisions of a trust may be in conferring power to engage in self-dealing or other transactions involving a conflict of fiduciary and personal interests, a trustee violates the duty of loyalty to the beneficiaries by acting in bad faith or unfairly. ⁹

HOW DOES THIS LOOK IN LITIGATION

- Miller v. Bank of America, N.A., 2015 WL 3654757. Supreme Court of New Mexico
 - Bank as Trustee and Lender
 - Damages under no further inquiry rule
 - Punitive damages in trust litigation

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Conflicts of Interest - Some Relevant Bulletins ¹⁰

05/08/2017 OCC 2017-16	<u>Fiduciary Powers: Revised Comptroller's Licensing Manual Booklet</u>
05/19/2016 OCC 2016-17	<u>Money Market Funds: Compliance With SEC Money Market Fund Rules by Bank Fiduciaries, Deposit Sweep Arrangements, and Bank Investments</u>
01/14/2015 OCC 2015-3	<u>Conflicts of Interest: Revised Comptroller's Handbook Booklet and Rescissions</u>
10/30/2013 OCC 2013-29	<u>Third-Party Relationships: Risk Management Guidance</u>
08/23/2012 OCC 2012-22	<u>Unique and Hard-to-Value Assets: New Comptroller's Handbook Booklet</u>
04/04/2011 OCC 2011-12	<u>Sound Practices for Model Risk Management: Supervisory Guidance on Model Risk Management</u>
09/20/2010 OCC 2010-37	<u>Fiduciary Activities of National Banks: Self-Deposit of Fiduciary Funds</u>
03/06/2008 OCC 2008-5	<u>Conflicts of Interest: Risk Management Guidance-Divestiture of Certain Asset Management Businesses</u>
02/05/2007 OCC 2007-7	<u>Soft Dollar Guidance: Use of Commission Payments by Fiduciaries</u>
05/10/2004 OCC 2004-20	<u>Risk Management of New, Expanded, or Modified Bank Products and Services: Risk Management Process</u>
01/05/2004 OCC 2004-2,	<u>Banks/Thriffs Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates</u>

RECENT REGULATORY ATTENTION

OCC – Comptroller’s Handbook – Conflicts of Interest – January 2015

DOL – Definition of term “Fiduciary”; Conflicts of Interest Rule – Retirement Investment Advice

SEC – Share Class Selection Disclosure Initiative – February 12, 2018

- Rule making coming soon

CFP Board – Code of Ethics and Standards of Conduct – March 2018
(effective 10/1/19)

HOW WE ADDRESS CONFLICTS

- Seek Authority
 - Statutory
 - Examples from Illinois

Illinois Trusts and Trustees Act

- Own – bank deposits (760 ILCS 5/4.06)¹¹

Sec. 4.06. To enter into agreements for bank or other deposit accounts, safe deposit boxes, custodian, agency or depositary arrangements for all or any part of the trust estate, including agreements for such services provided by a bank operated by or affiliated with the trustee, and to pay reasonable compensation for those services, including compensation to the bank operated by or affiliated with the trustee, except that nothing in this Section shall be construed as removing any depositary arrangements from the requirements of the prudent person rule. (Source: P.A. 85-1211; 86-1475.)

- Dealing with Executors (760 ILCS 5/4.15)¹¹

Sec. 4.15. To deal with the executor, trustee or other representative of any other trust or estate in which a beneficiary of the trust estate has an interest, notwithstanding the fact that the trustee is an executor, trustee or other representative of the other trust or estate. (Source: P.A. 86-1475.)

HOW WE ADDRESS CONFLICTS

Illinois Trusts and Trustees Act

- Investments in Mutual Funds (760 ILCS 5/5.2)¹¹

Sec. 5.2. Investments in mutual funds. A trustee, including a trustee of a common trust fund, may invest and reinvest the trust estate in interests in any open-end or closed-end management type investment company or unit investment trust registered under the Investment Company Act of 1940 or any investment fund exempt from registration under the Investment Company Act of 1940, any of these investment companies, unit investment trusts, or investment funds being a "mutual fund" for purposes of this Section, or may retain, sell, or exchange those interests, provided that the portfolio of the mutual fund, as an entity, is appropriate under the provisions of this Act. A trustee shall not be prohibited from investing, reinvesting, retaining, or exchanging any interests held by the trust estate in any mutual fund for which the trustee or an affiliate acts as advisor or manager or in any other role solely on the basis that the trustee (or its affiliate) provides services to the mutual fund and receives reasonable remuneration for those services. Neither a trustee nor its affiliate shall be required to reduce or waive its compensation for services provided in connection with the investment, management, and administration of the trust estate because the trustee invests, reinvests, or retains the trust estate in a mutual fund, so long as the total compensation paid by the trust estate as trustee's fees and mutual fund fees, including any advisory or management fees, in connection with the investment of a trust estate in a mutual fund is reasonable; provided, however, that a trustee may receive Rule 12b-1 fees equal to the amount of those fees that would be paid to any other party. (Source: P.A. 90-297, eff. 8-1-97.)

SAMPLES OF STATE LAW EFFORTS

Illinois Corporate Fiduciary Act

- Retention of Agents (205 ILCS 620/2-11)¹¹

Sec. 2-11. Retention of agents and advisors. A corporate fiduciary may hire and compensate, as an additional expense of the trust or estate, agents, advisors (including financial, investment, and other advisors), and brokers (including brokers for the sale or purchase of securities or other property) to assist or advise the corporate fiduciary in the performance of its duties, including persons and entities associated or affiliated with the corporate fiduciary.

(Source: P.A. 89-205, eff. 1-1-96; 89-364, eff. 8-18-95; 90-298, eff. 8-1-97.)

HOW WE ADDRESS CONFLICTS

- Documentary
 - Sample trust language

(1) Power to invest in or retain any securities or other property, real or personal (within or without the United States), including by way of illustration, but not limitation: any security as defined by the Securities Act of 1933 or other applicable law, any contract of sale of a commodity for future delivery within the meaning of the Commodity Exchange Act, shares or interests in any private investment fund, private equity or venture capital fund, hedge fund, common trust fund, joint venture, general or limited partnership, limited liability company, statutory or common law business trust, statutory trust, real estate investment trust or an open-end (including any mutual fund) or closed-end management type investment company or unit investment trust, whether registered under the Investment Company Act of 1940 or unregistered, any money market instrument, bank deposit account (including but not limited to savings, time, certificate of deposit and transaction accounts), precious metal, foreign exchange, structured product, insurance contract, options, options on futures and variable forward contracts, swaps, caps, collars and other derivative instruments of a financial nature, notwithstanding the fact that the trustee, investment manager or custodian, its respective parent or any affiliate, is an issuer of such investment or provides services (whether as manager, underwriter, distributor, custodian, advisor, agent, servicer, trustee or otherwise) with respect to any such investment and further notwithstanding that the trustee, investment manager, custodian or its respective parent or any affiliate may receive compensation with respect to any such investment (in addition to trustee's commissions), so long as the total compensation received is reasonable. To the extent permitted by applicable law, this provision is intended to override any contrary provision of law prohibiting such additional fees or otherwise requiring either a reduction in trustee's commissions or an election between such additional fees and such commissions. Any diversification requirement that would otherwise apply, including one imposed by a Prudent Investor Act or similar applicable law, is negated.

HOW WE ADDRESS CONFLICTS

- Documentary

- Sample language (cont'd)

(2) Power to employ such agents, advisors and other counsel, including but not limited to entities affiliated with any trustee, and to pay out of income or principal or both the reasonable charges and fees of such agents, advisors and counsel, as it shall in its sole discretion determine, including the power to select brokers and dealers affiliated with any trustee for the sale or purchase of any securities or other investment property in the trust. This authorization shall include, but shall not be limited to, an affiliated broker acting in a principal or agency capacity for equity and fixed income securities, routing orders for over-the-counter (OTC) stocks to a market maker affiliated with any trustee, routing listed stocks to specialists affiliated with any trustee, routing listed options through a proprietary trading operation affiliated with any trustee, or routing after-hours orders to a proprietary trading operation in which any trustee or an affiliate owns an equity interest. In such case the trustee or an affiliate may receive both monetary and non-monetary “payment for order flow,” including, without limitation, an inter-company transfer of funds in connection with orders routed to an affiliated market maker; monetary compensation (including fee sharing) from, and participation in the profits of, certain affiliated and independent exchange specialists who execute orders; other compensation as part of reciprocal order routing arrangements with various exchange specialists and dealer firms; and rebates and credits against fees paid by various exchanges to member firms. To the extent permitted by applicable law, the trustee’s compensation shall not be reduced by any additional compensation received by the trustee, its parent, or any affiliate thereof, or any agent, principal, advisor, counsel, broker, dealer, market maker or specialist (including exchange specialist) affiliated with the trustee, its parent or any affiliate thereof, for providing any of the services authorized in this paragraph.

- Consent of clients / beneficiaries

- Non-judicial settlement agreements

HOW TO THINK ABOUT CREATING A FRAMEWORK FOR COMPLIANCE

- Enterprise Policies and Procedures
 - Code of Conduct
 - Outside business activities
- Enterprise conflicts risk coverages
 - Affiliate Transaction – Reg W
 - Associate Investment Monitoring
- Line of Business Policies and Procedures
 - Conflicts Policy
 - Fiduciary Proxy voting
 - Fiduciary conflicts: generally
- Line of Business Conflicts Officers
 - Duties and Responsibilities

CONFLICT TYPES AND MANAGEMENT

- Firm vs. Client
- Officers/Directors vs. Client
- Officers/Directors vs. Firm
- Client vs. Client
- Vendor vs. Client
- Risk Areas
 - Firm Activities
 - Compensation, hiring, referrals, sale, product development, training, proxy voting
 - Officer Activities
 - Gifts, outside business, privacy, personal finance, political activity
 - Management
 - Monitoring – Conflicts Officer
 - Escalation – Officers
 - Oversight – Conflicts Executive
 - Training – Line of Business / Enterprise
 - Advice – Conflicts Experts

WHAT DO CONFLICTS LOOK LIKE IN YOUR WORLD?

- Bank officer goes to work at a vendor
 - Trust officer goes to work at local RIA
 - In-house counsel goes to law firm
- Philanthropic officer serves on not-for-profit board
 - Grant-making conflicts
- Large corporate client calls in advance of annual shareholder meeting to discuss votes on shareholder initiatives
- Financial Advisor and her children are named beneficiaries in client's estate planning documents. Financial Advisor requests fee exception on client's account.
- Client, sole current permissible distributee of a trust, and his counsel insist that the Bank not send statements to the client's children, the remainder beneficiaries of the trust.

CONFLICTS

Fiduciary Bane

Or

Blessing in Disguise

- Embrace our status
- Where trust law began, the market is moving

“Many years ago, there used to be something called ‘conflict of interest.’ No longer, I’m afraid. Today, we all bathe in the same river.”

— Gore Vidal, The Last Empire: Essays 1992-2000

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